Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:TL-N-3786-01
[redacted]

date: AUG 7 2001

to: Team Manager, LMSB, [redacted]
Attn: Revenue Agent [redacted]

from: Area Counsel
[redacted]

subject: **Request for LMSB Division Counsel Assistance: [redacted] - Deductibility of Break-up Fee**

We respond to your request for assistance. Our recitation of the facts as we know them, analysis, and recommendation follow. This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE

May the taxpayer deduct a $[redacted] fee paid to a corporation for breaching an agreement to be acquired by it where, at the same time, the taxpayer agreed to be acquired by another corporation?

CONCLUSION

Under the facts of this case, the fee paid for breaching a preexisting agreement to be acquired by one company must be capitalized, and thus, is not deductible by the taxpayer in the year paid. Because of the factual nature of this issue, however, we recommend certain efforts to further develop this position.

FACTS

The taxpayer, [redacted], was a [redacted] company that was spun off from [redacted] in [redacted]. In [redacted], the taxpayer investigated the "strategic alternatives" available to it, which included either acquiring, or merging with, another [redacted] company. The minutes of the taxpayer's board of directors for [redacted], discuss these "strategic alternatives." In the director's meeting of [redacted], the board expressed its preference for investigating a strategic transaction with [redacted]. Two directors were appointed to investigate the possibilities.

After some analysis, the taxpayer's board decided to sell the company, that being the best alternative for shareholders. The taxpayer first contacted [redacted], and subsequently contacted [redacted], to solicit offers to acquire the taxpayer. Each company submitted an offer.

The taxpayer hired an expert to evaluate both offers. The expert opined that both offers were roughly equal, but that the [redacted] offer had a slight advantage, as [redacted] offered a slightly higher price for the stock. It also appeared that the taxpayer made a better business fit with [redacted] than with [redacted].

The minutes of the taxpayer's [redacted], board meeting reflect that the taxpayer considered the two offers, and unanimously decided that the [redacted] offer was more attractive than the [redacted] offer. The minutes reflect the following:

> The unanimous decision of the Board of Directors was to proceed to negotiate a definitive merger agreement with [redacted] while continuing to keep available the option to choose any future offer - from [redacted], [redacted] or any other part_ - that _ight be made and found to be superior to the present [redacted] offer.

It then passed two resolutions: the first authorized the taxpayer's corporate officers and an outside director to negotiate a definitive merger agreement with [redacted] on the basis of its offer, provided that the reciprocal termination fees did not exceed $[redacted]; the second was an agreement to negotiate any sale of the business exclusively with [redacted] through [redacted].

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[1] Statement of [redacted], [redacted], [redacted]

Board minutes indicate that, on [redacted], it discussed the $[redacted] fee, and concluded that it could be incurred in a reasonable exercise of business judgment of the board of directors without impairing the taxpayer's ability to consider and accept a subsequent better offer from [redacted] for any reason.

On [redacted], an Agreement and Plan of Merger Between [redacted] and [redacted] was executed. This agreement called for, among other things, payment of $[redacted] as a termination fee should either party terminate the agreement. It also called for up to $[redacted] in reasonable out-of-pocket expenses to be reimbursed in the event of termination. That same day, outside counsel for the taxpayer's board advised that the contract restricted the solicitation of other proposals, but permitted consideration of unsolicited proposals. He further discussed the provisions allowing the taxpayer to terminate the proposed Agreement and Plan of Merger to facilitate acceptance of other unsolicited proposals.

On [redacted], [redacted] submitted an unsolicited offer to the taxpayer, increasing its prior offer by more than [redacted] percent. At a [redacted] board meeting, the board's outside counsel advised "that to engage in any discussions with [redacted] regarding the [redacted] Proposal the Board of Directors must first satisfy § [redacted] of the Agreement and plan of Merger dated as of [redacted] . . ., which would prohibit any discussions with [redacted] unless the Board of Directors 'determines in good faith, after consultation with counsel and its financial advisors, that failing to take such action would create a reasonable possibility of a breach of fiduciary duties of the Board of Directors.'" Thereafter, the taxpayer's Board passed a resolution setting forth its determination that failing to discuss the [redacted] proposal created a reasonable possibility of such a breach.[2]

On [redacted], representatives of the taxpayer reported to the taxpayer's Board that the general reaction of the investing community was more favorable to the [redacted] proposal than to the [redacted] agreement. On [redacted], pursuant to the agreement, [redacted] demanded of, and received, the

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2 The Board further voiced its concern that the Securities and Exchange Commission would change from allowing the taxpayer and [redacted] to use "pooling of interests" accounting treatment because the payment of a termination fee of the magnitude contemplated by the [redacted] agreement was inconsistent with that accounting treatment. Ultimately, the Commission consented to its use, despite the termination fee payment.

taxpayer's reaffirmation to carry out the [redacted] merger agreement.

On [redacted], the taxpayer invited [redacted] and [redacted] to make presentations to the taxpayer's Board. [redacted], which increased its offer by slightly more than [redacted] percent over the amount agreed to on [redacted], included in this proposal the following statement of [redacted]:

> I would like to stress that the only reason that the [redacted] Board was willing to approve the increase to the previously negotiated and agreed-to conversion number was to put an immediate end to the auction process that [redacted] has allowed to occur between [redacted] and [redacted] since [redacted] of last year.

[redacted] reiterated its offer of [redacted], in its presentation. However, immediately thereafter, [redacted] increased its offer by another [redacted] percent over its original offer, and agreed to pay the taxpayer $[redacted] if an agreement between the taxpayer and [redacted] were terminated under certain circumstances. On [redacted], the taxpayer accepted [redacted]'s proposal. In accordance with the terms of the [redacted], agreement, the taxpayer paid [redacted] $[redacted] for terminating the agreement. It is unknown whether the taxpayer paid any out-of-pocket expenses to [redacted].

The taxpayer reported a deduction for abandonment loss of $[redacted], of which amount $[redacted] is attributable to the [redacted] termination fee, on its return for the taxable year ended [redacted].

ANALYSIS

I.R.C. § 162(a) allows a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." In contrast, section 263 allows no deduction for a capital expenditure - an "amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Section 263(a)(1). This characterization of payments as either a business expense or a capital expenditure determines the timing of a taxpayer's cost recovery: business expenses are currently deductible; in contrast, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. <u>INDOPCO, Inc. v. Commissioner</u>, 503 U.S. 79, 83-84 (1992).

In INDOPCO, the Court required a corporation to capitalize investment banking fees, legal fees, and other costs incurred in a friendly merger. There, the Court held that, beyond requiring capitalization for expenditures that created a separate and distinct capital asset, costs that provide a benefit in future tax years without the creation of such assets may compel capitalization. Id., 503 U.S. at 86-87. The Court cautioned, however, that the "mere presence of an incidental future benefit-'some future aspect'- may not warrant capitalization." Id.

Future Benefit

In United States v. Federated Dep't Stores (In re Federated Dep't Stores), 171 B.R. 603 (S.D. Ohio 1994), a taxpayer was permitted to deduct break-up fees paid upon the success of the hostile tender offers that it made to acquire two separate retail chains. There, the raider, Campeau, launched hostile tender offers for two targets, Allied and Federated (each part of the taxpayer). In an attempt to avoid the hostile takeovers, both Allied and Federated engaged in defensive measures, and entered into white knight proposals with DeBartolo and Macy, respectively. These defenses failed to prevent Campeau's takeover of each target. In accordance with agreements between the targets and the white knights, break-up fees were paid to the white knights when the transactions to defend Allied and Federated from Campeau's acquisition fell through. Id., 171 B.R. at 609-610.

The Federated court found that the subject hostile takeovers by Campeau did not provide Federated or Allied with the type of synergy found in INDOPCO. In contrast to INDOPCO, where the Court found that the synergy created by the target's newly acquired access to the acquiring company's resources and distribution network would provide significant long-term benefits, the Federated court concluded that the takeover of two large department store chains with wholly unrelated business operations by an acquirer inexperienced in the the retailing field imparted no long-term benefit. Federated, 171 B.R. at 609 (citing INDOPCO, 503 U.S. at 88-89). Further, the trial court held that the break-up fees were an attempt to defend the business against attack, not to restructure the corporation. Federated, 171 B.R. at 610.

Likewise, the facts concerning [redacted]'s acquisition of the taxpayer transformed it into the [redacted] of [redacted], and the [redacted] company [redacted] Moreover, the taxpayer had targeted combination with another [redacted] company in its "strategic alternatives" evaluation in [redacted]. Combination with [redacted] for a higher price, despite the

$[redacted] it had to pay [redacted] as the termination fee, still furthered the taxpayer's plan of selling to the highest bidder. We recommend that, if not already obtained, you request a written analysis of the "strategic alternatives" that was presented to the taxpayer's board of directors.

Defense of Business

The costs incurred to defend a business against attack are ordinary and necessary expenses. See NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982); Locke Mfg. Cos. v. United States, 237 F. Supp. 80 (D. Conn. 1964) (permitting a corporation to deduct expenses incurred in a successful defense to proxy fight); Central Foundry Co. v. Commissioner, 49 T.C. 234 (1967) (allowing deduction of proxy fees incurred in an unsuccessful defense). These cases reasoned that the expenses were incurred to protect corporate policy and structure, not to acquire a new asset. NCNB Corp. 684 F.2d at 290.

In contrast, expenditures incurred to change a corporation's structure must be capitalized. See General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir.), cert. denied, 379 U.S. 832 (1964). Whether the break-up fees were incurred to restructure the corporation in hopes of some future benefit is a factual matter. Federated, 171 B.R. at 610. While the benefit of hindsight should not be used to determine the classification of an expenditure, it is useful to assess the validity of the parties' positions. Id.

The question of deductibility turns on whether the costs incurred in this case are more properly viewed as costs associated with defending a business or as costs associated with facilitating a capital transaction. See Woodward v. Commissioner, 397 U.S. 572 (1970). In A.E. Staley Mfg. Co. v. Commissioner, 119 F.3d 482 (7th Cir. 1997), the white knight with whom the taxpayer had been dealing ultimately made a successful tender offer for the taxpayer, without the taxpayer's approval. In holding the costs incurred in trying to fend off that acquirer to be deductible, the court found that the taxpayer was engaged in the process of defending its business from attack. Moreover, it relied on the statements of the taxpayer's board of directors that found the white knight's offer inadequate, stating that the suitor 'brought nothing to the table' in terms of capital, marketing, or research and development and, also, because the white knight intended to abandon the taxpayer's diversification plan. Id., 119 F.3d at 489 (citing A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166, 174 (1995).

While we believe that the facts, as known now, favor a finding that the termination fee was part of the taxpayer's restructuring and, as such, a capital cost, we suspect that the taxpayer will point to the later overtures from [redacted] as "hostile" or, at least, unsolicited. (b)(5)(AC), (b)(7)a [redacted].

Abandonment

Section 165 allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. To be deductible, a loss must be "evidenced by closed and completed transactions, fixed by identifiable events, and [with exceptions not applicable here,] actually sustained during the taxable year." Treas. Reg. § 1.165-1(b). While not specified in the Code, the regulations allow deductions for an abandonment loss if the taxpayer incurs it in a business or a transaction entered into for profit, and it arises from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued, or where such property is permanently discarded from use therein. Treas. Reg. § 1.165-2(a). Accordingly, merger and acquisition costs, otherwise capitalizable, are deductible under section 165 when the transaction is abandoned. Rev. Rul. 73-580, 1973-2 C.B. 86.

Case law holds that where a taxpayer engages in multiple separate and distinct transactions, costs properly allocated to abandoned transactions are deductible even if other transactions are completed. Sibley, Lindsay & Curr Co. v. Commissioner, 15 T.C. 106 (1950), acq., 1951-1 C.B. 3. Further, if a taxpayer engages in a series of transactions and abandons one of those transactions, a loss is allowed even if the taxpayer later proceeds with a similar transaction. Tobacco Products Export Co. v. Commissioner, 18 T.C. 1100, 1104 (1952); Portland Furniture Manufacturing Co. v. Commissioner, 30 B.T.A. 878 (1934); Doernbecher Mfg. Co. v. Commissioner, 30 B.T.A. 973 (1934), acq., XIII-2 C.B. 6, aff'd, 80 F.2d 573 (9th Cir. 1935). In summary, deductions are permitted upon the abandonment of separate and distinct transactions even if subsequent or alternative independent transactions are pursued.

However, if the proposals are alternatives, only one of which can be completed, no abandonment loss is proper unless the taxpayer abandons the entire transaction. Haspel v. Commissioner, 62 T.C. 59, 72-73 (1974) (architect expenses for discharged architect are not deductible where the building was constructed); see also Driscoll v. Commissioner, 147 F.2d 493 (5th Cir. 1945). In Galt v. Commissioner, 19 T.C. 892 (1953), aff'd in part and rev'd in part on another issue, 216 F.2d 41 (7th Cir. 1954), the court rejected a taxpayer's efforts to deduct professional fees attributable to unsuccessful efforts to lease property that was ultimately leased during that year, noting that the professional was hired to help attain a single objective - lease of the premises. Id., 19 T.C. at 911. See also Nicolazzi v. Commissioner, 79 T.C. 109 (1982) (investment was viewed as one concerted transaction rather than 600 separate efforts to obtain leases, only one of which was successful). Stated differently, an abandonment loss is not allowable for proposals that are mutually exclusive alternate methods of reaching a desired goal.

Again, our view is that the facts more favor a finding that the taxpayer's attempt to enter into a merger agreement with an acceptable [redacted] company - where the taxpayer itself identified both [redacted] and [redacted] as meeting this criterion - was the transaction, and that it was not abandoned when [redacted] made a final bid that was more acceptable than [redacted]'s final bid.

CONCLUSION

We see this factual pattern as more analogous to the friendly merger found in the facts of INDOPCO than the proxy battle depicted in the Federated facts. Based on this, we believe that the $[redacted] termination fee, and any additional [redacted] expenses that the taxpayer paid pursuant to the termination of the [redacted] merger agreement, should be capitalized as part of the costs associated with [redacted]'s acquisition of the taxpayer. (b)(5)(AC), (b)(7)a [redacted].

Please do not hesitate to contact [redacted] if you need further assistance concerning this matter, at [redacted], ext. 259.

[redacted]
Area Counsel
[redacted]

By: [redacted]
Associate Area Counsel (LMSB)